such use would be confiscatory.[415] The current prescribed rate of return on interstate services is 11.25 percent.[416] We sought comment on our proposal.[417]

Comments:

161. Most commenters that address this issue argue that the Commission should require the BOCs to use the prescribed interstate rate of return for valuing transactions with their affiliates engaged in activities permitted under section 272.[418] PacTel and SBC contend that the prescribed interstate rate of return is consistent with the return on investment that a BOC could anticipate if it were to use its investment to provide services to third parties.[419] TRA argues that allowing carriers to select their own rate of return, instead of using the prescribed interstate rate of return, would run counter to the Commission's efforts to promote arm's length transactions and would unduly burden the Commission with numerous rate-of-return prescription proceedings.[420]

162. US West, however, disagrees. US West argues that the Commission should permit any BOC to determine the return component included in its cost computations for valuing affiliate transactions using a composite of the prescribed interstate rate of return and the intrastate rates of return prescribed or authorized for that carrier.[421] US West contends that this approach would recognize that transactions between a BOC and its affiliate benefit both the interstate and intrastate services that a BOC provides to third parties.[422] USTA argues that

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[415] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, Report and Order, CC Docket No. 92-133, 10 FCC Rcd 6788 (1995) ("Rate of Return Order").

[416] The Bureau has released a Public Notice seeking comment on whether the Commission should commence a represcription proceeding. Common Carrier Bureau Sets Pleading Schedule for Preliminary Rate of Return Inquiry, Public Notice, DA 96-139, 61 Fed. Reg. 6641 (rel. Feb. 21, 1996).

[417] NPRM, 11 FCC Rcd at 9096 para. 88.

[418] See, e.g., AT&T Comments at 17; GSA Comments at 6; PacTel Comments at 29; SBC Comments at 41; TRA Comments at 19; GSA Reply at 10.

[419] PacTel Comments at 29; SBC Comments at 41.

[420] TRA Comments at 19.

[421] US West Comments at 20. See also NYNEX Reply at 18 (arguing that an incumbent local exchange carrier should have "the option of using a different rate of return so that [it] could meet its obligations to both federal and State regulators and reduce its record-keeping burden").

the current rules are adequate because they permit a BOC to utilize a rate of return that is "appropriate for affiliate transactions" and require the carrier to reference that rate of return, if different from the prescribed interstate rate of return, in its cost allocation manual.[423]

163. MCI argues that the Commission should set the uniform rate of return for determining the fully distributed costs associated with affiliate transactions involving the services permitted by section 272 at 10.25 percent, the lowest point of the range that the Commission allows under its price cap plan.[424] MCI maintains that an affiliate relationship reduces a supplier's business risks and therefore lowers the necessary return.[425] NYNEX argues that the Commission should reject MCI's suggestion. NYNEX contends that the fact that a price cap carrier subject to sharing/low-end adjustments can seek a low-end adjustment if its interstate earnings fall below 10.25 percent does not provide a basis to establish 10.25 percent as a reasonable return component.[426] NYNEX notes that many carriers are not subject to sharing/low-end adjustments.[427] Finally, NYNEX argues that determination of business risk, cost of capital and rate of return for particular nonregulated affiliates would be extremely complicated.[428]

Discussion:

164. When an incumbent local exchange carrier provides services or assets to an affiliate, or an affiliate provides services or assets to an incumbent local exchange carrier, where the transferred goods or services are not provided pursuant to tariff or eligible for prevailing price valuation (i.e. substantial amount of the transferred goods or services are not provided to unaffiliated third parties), the transactions typically do not involve the risk inherent in providing services or assets in a competitive market. This is because any investment required to provide the service or asset will not be subject to competitive pressure from alternative suppliers. The cost of capital to be imputed in such transactions should meet

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422 Id.

423 USTA Comments at 24.

424 MCI Comments at 28.

425 Id. at 28-29.

426 NYNEX Reply at 19.

427 Id.

428 Id.

two criterion: one, it should impute a reasonable rate of return, and two, it should be uniform for all carriers and transactions. The latter criteria, uniformity, avoids the unduly burdensome calculation of a rate of return and time-consuming carrier-specific rate of return prescription.

165. We conclude that a reasonable rate of return to be used by all incumbent local exchange carriers in determining the fully distributed costs associated with affiliate transactions is the rate of return on interstate services, as amended periodically by the Commission. In establishing the prescribed interstate rate of return, the Commission considered the cost of capital to provide interstate access services and prescribed a rate of return of 11.25% for the local exchange carriers.[429] The Commission concluded that this rate of return for the regulated activities of local exchange carriers would maintain the carriers' financial integrity and enable them to attract new capital necessary to serve the public. The Commission followed the Supreme Court's holding in *FPC v. Hope Natural Gas Co.* that the rate prescribed should be "commensurate with returns on investments in other enterprises having corresponding risks."[430] In concluding that the prescribed interstate rate of return is a reasonable rate of return to be used in affiliate transactions, we agree with PacTel and SBC that the prescribed interstate rate of return is consistent with the return on investment that an incumbent local exchange carrier could anticipate if it were to use its investment to provide services to third parties. We also disagree with the approach of US West to use a blended rate of return for interstate and intrastate services because there are states that no longer prescribe a rate of return for intrastate services. The approach of US West and that of USTA also would not allow the application of a uniform or easily determinable rate of return.

166. In the *Interconnection Order*, we concluded that "the currently authorized rate of return at the federal or state level is a reasonable starting point . . . and incumbent [local exchange carriers] bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital."[431] We similarly conclude that for all affiliate transactions, incumbent local exchange carriers bear the burden of demonstrating with

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[429] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, CC Docket No. 89-624, 5 FCC Rcd 7507 (1990).

[430] 320 U.S. 591, 603 (1944).

[431] Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers, Report and Order, CC Docket Nos. 95-185, 96-98, FCC 96-325, para. 702 (rel. Aug. 8, 1996) ("Interconnection Order"), Order on Reconsideration, 11 FCC Rcd 13042 (1996), further recon. pending, pet. for review pending sub nom. and partial stay granted, Iowa Utilities Board v. FCC, No. 96-3221 and consolidated cases (8th Cir. filed Sept. 6, 1996), partial stay lifted in part, Iowa Utilities Board v. FCC, No. 96-3321 and consolidated cases, 1996 WL 589284 (8th Cir Oct. 15, 1996).

specificity that the business risks that they face in providing services to their affiliates would justify a risk-based adjustment to the cost of capital that would result in a rate of return different than 11.25%. We note, however, that we apply the prescribed rate of return on interstate services to affiliate transactions solely to determine the fully distributed costs associated with such transactions for accounting purposes and not to determine the prices charged for these services.

c. Accounting Requirements of Sections 272(b)(2) and (c)(2)

167. Section 272(b)(2) requires the separate affiliates prescribed under section 272(a)(2) to "maintain books, records, and accounts in the manner prescribed by the Commission which shall be separate from the books, records, and accounts maintained by the [BOC] of which it is an affiliate."[432] In the *NPRM*, we asked what steps the Commission should take in order to implement this requirement and, in particular, whether we should mandate that separate affiliates required under section 272(a)(2) maintain their books, records, and accounts in accordance with generally accepted accounting principles ("GAAP") or whether it is necessary for the Commission to adopt any additional accounting, bookkeeping or record-keeping requirements for affiliates prescribed under 272(a)(2).[433]

Comments:

168. Most parties, including several BOCs, argue that at most we should require separate affiliates under section 272(a)(2) to maintain their books, records, and accounts in accordance with GAAP.[434] TRA contends that GAAP will ensure that costs are based upon reliable data and will create a more uniform audit trail with minimal cost and without a drastic restructuring of carriers' accounting systems.[435] US West maintains that GAAP is a reasonable requirement because it is widely employed and commonly understood.[436]

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[432] 47 U.S.C. § 272(b)(2).

[433] NPRM, 11 FCC Rcd at 9086 para. 68.

[434] Ameritech Comments at 22; APCC Comments at 22; Bell Atlantic Comments at 13; BellSouth Comments at 23; CTA Comments at 15; TRA Comments at 6; USTA Comments at 22; US West Comments at 12; Worldcom Comments at 22; NYNEX Reply at 13; TIA Reply at 10; Worldcom Reply at 13.

[435] TRA Comments at 6.

[436] US West Comments 12.

169. AT&T and MCI argue that all BOC affiliates except non-carrier affiliates should maintain their books pursuant to the Commission's Uniform System of Accounts.[437] In particular, MCI contends that standardization of Part 32 accounting between a BOC and its in-region interLATA affiliate will enable the Commission to make earnings comparisons and comparisons of investment and expenses that are critical to the Commission's ability to identify instances where a BOC is possibly subsidizing an interLATA affiliate.[438] Worldcom maintains that we should require all BOC affiliates to maintain books in conformance with Part 32's Uniform System of Accounts to facilitate auditing.[439]

Discussion:

170. We conclude that the separate affiliates prescribed under section 272(a)(2) must maintain their books, records, and accounts in accordance with GAAP. We concur with TRA that a requirement that these affiliates maintain their books, records, and accounts in accordance with GAAP will result in a uniform audit trail at minimal cost. Moreover, a requirement of GAAP for separate affiliates required under section 272(a)(2) imposes some degree of uniformity upon these affiliates. We are not persuaded by parties' comments, however, that we should impose Part 32 accounting systems on BOC affiliates in order to facilitate auditing. We currently do not impose Part 32 accounting on the interexchange telecommunications affiliates of non-BOC incumbent local exchange carriers.[440] Moreover, BOCs are currently required to clearly and completely document the manner in which affiliates' accounting systems flow into the BOCs' Part 32 accounts. Accordingly, we find no reason to impose the additional burden of requiring separate affiliates required under Section 272(a)(2) to maintain their books, records, and accounts in accordance with the Part 32 Uniform System of Accounts.

d. Application to InterLATA Telecommunications Affiliates

171. Our existing affiliate transactions rules are designed solely for transactions between regulated carriers and their nonregulated affiliates.[441] InterLATA telecommunications

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[437] AT&T Comments at 9, 12; MCI Comments at 17, 18.

[438] MCI Comments at 18.

[439] Worldcom Comments at 22-23.

[440] For example, GTE, Cincinnati, Rochester, and Sprint presently operate interexchange telecommunications affiliates that are not subject to Part 32 accounting.

[441] See Joint Cost Reconsideration Order, 2 FCC Rcd at 6297 para. 122.

services, however, are subject to Title II of the Act, and, absent a Commission determination to the contrary, the affiliates that offer those services would classify interLATA telecommunications services as "regulated" for Title II accounting purposes. In the *NPRM*, we tentatively concluded that we should apply our affiliate transactions rules to transactions between each BOC and any regulated interLATA telecommunications affiliate it establishes under section 272(a).[442] We invited comment on this tentative conclusion and asked how we would need to modify our affiliate transactions rules if applied to such transactions.

172. Section 272 does not prohibit a BOC from providing more than one nonregulated service (*e.g.*, manufacturing and an interLATA information service) through the same affiliate. It also does not prohibit an affiliate that provides regulated services such as interLATA telecommunications services, from engaging in other activities not regulated under Title II. In the *NPRM*, we sought comment on whether, in this context, we should apply our cost allocation rules to prevent subsidization of nonregulated activities by subscribers to interLATA telecommunications services, and whether section 254(k) authorizes such an application of our cost allocation rules.[443]

Comments:

173. Most commenters addressing this issue argue that the Commission should treat interLATA telecommunications services, such as in-region interLATA services, like a nonregulated activity for accounting purposes.[444] As a result, these commenters maintain that the existing affiliate transactions rules will prevent subsidization between local exchange and exchange access services and these interLATA telecommunications services.

174. BellSouth, however, opposes application of the affiliate transactions rules to transactions between a BOC and its affiliate established under section 272(a). BellSouth contends that there is no need to apply these rules because both the BOC and the new interLATA telecommunications affiliate are subject to Title II of the Act and, therefore, must establish just, reasonable and nondiscriminatory rates. In addition, BellSouth argues that, because the separate affiliate requirement of section 272 sunsets after three years, the costs

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[442] NPRM, 11 FCC Rcd at 9097 para. 89.

[443] Id. at para. 90.

[444] See, e.g., AT&T Comments at 9; CTA Comments at 15; GSA Reply at 6; PacTel Comments at 29; US West Comments at 21; USTA Comments at 24; Worldcom Reply at 13. See also MCI Comments at 33; TRA Comments at 20.

incurred to create internal accounting and tracking systems to comply with the affiliate transactions rules would increase administrative costs with no corresponding benefit.[445]

175. Worldcom and MCI argue that the Commission should apply its cost allocation rules to prevent subsidization of nonregulated activities by interLATA services.[446] USTA and all of the BOCs that address this issue, however, oppose the application of cost allocation rules to prevent subsidization of nonregulated activities by subscribers to interLATA telecommunications services.[447] They contend that BOC affiliates have no incentive to subsidize nonregulated activities by subscribers to interLATA telecommunications services because both services are competitive.[448] Bell Atlantic further argues that the Commission has no authority to regulate transactions within or among affiliates.[449]

Discussion:

176. Section 272(b)(5) requires BOC affiliates established under section 272(a), such as an affiliate providing in-region services, to "conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis." Our existing affiliate transactions rules are designed solely for transactions between regulated carriers and their nonregulated affiliates.[450] These rules therefore do not currently protect against a flow of subsidies from a BOC's exchange services and exchange access to its affiliate providing regulated interLATA telecommunications services, such as in-region services. We conclude that under the current affiliate transactions rules, we can satisfy section 272(b)(5)'s "arm's length" requirement by treating interLATA telecommunications services like a nonregulated activity strictly for accounting purposes. We therefore adopt our tentative conclusion that we should apply our affiliate transactions rules to transactions between each BOC and any interLATA telecommunications affiliate it establishes under section 272(a), such as an affiliate providing in-region services, and order that the BOCs treat such services like nonregulated activities for accounting purposes.

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[445] BellSouth Comments at 37.

[446] MCI Comments at 34; Worldcom Comments at 29.

[447] Ameritech Comments at 24; BellSouth Comments at 38; PacTel Comments at 29; SBC Comments at 41; USTA Comments at 25.

[448] See, e.g., Ameritech Comments at 24; PacTel Reply at 17; SBC Comments at 47.

[449] Bell Atlantic Comments at 14.

[450] See Joint Cost Reconsideration Order, 2 FCC Rcd at 6297 para. 122.

177. We find unpersuasive BellSouth's assertion that there is no need to apply our affiliate transactions rules to transactions between each BOC and any interLATA telecommunications affiliate it establishes under section 272(a), such as an affiliate providing in-region services. Despite BellSouth's assertion that interLATA telecommunications affiliates established under section 272 are subject to Title II of the Act and, therefore, must establish just, reasonable and nondiscriminatory rates, we believe we should apply our affiliate transactions rules, as modified in this Order, to satisfy our obligation to ensure that all transactions between BOCs and their section 272 affiliates are conducted at "arm's length."[451] Moreover, we disagree with BellSouth's contention that the administrative costs of imposing our affiliate transactions rules outweigh the corresponding benefit. To the greatest extent possible, we have relied upon our existing affiliate transactions rules to minimize the administrative burden associated with the implementation of a new system of accounting safeguards.

178. When a BOC affiliate provides both regulated Title II services permitted under sections 271 and 272, such as interLATA telecommunications services, and nonregulated activities, such as interLATA information services, we conclude that we need not apply our cost allocation rules to prevent subsidization of nonregulated activities by subscribers to these interLATA telecommunications services. We agree with those commenters that argue that market forces leave BOC affiliates with little ability to subsidize nonregulated activities by interLATA telecommunications services.

e. Application to Sharing of Services

179. In the *NPRM*, we tentatively concluded that if our companion *Non-Accounting Safeguards Order* were to conclude that an affiliate may share marketing personnel with a BOC then we should apply our cost allocation and affiliate transactions rules, as we proposed to modify them in our *NPRM*, to the BOC's Part 32 accounts to govern any joint marketing of interLATA and local exchange services.[452] We invited comment on whether any additional accounting safeguards may be necessary.

Comments:

180. MCI, NYNEX, Worldcom and TRA argue that if the *BOC In-Region Order* concludes that an affiliate may share marketing personnel with a BOC, the Commission's cost allocation and affiliate transactions rules must apply to the joint marketing of interLATA and

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[451] 47 U.S.C. § 272(b)(5).

[452] NPRM, 11 FCC Rcd at 9098 para. 91.

local exchange services.[453] MCI contends that the BOCs' cost allocation manuals must specify how they plan to estimate the fair market value of the marketing services they provide to their interLATA affiliates.[454]

181. Washington maintains that the Commission should require that the affiliate employ and pay for the shared marketing personnel with the costs allocated to the BOC based on time reporting and other auditable documentation.[455] USTA and several BOCs argue that the Commission need not impose any additional safeguards when a separate affiliate subject to the requirements of section 272(b)(3) shares in-house or outside services with a BOC.[456] USTA contends that although section 272 prohibits the BOCs and their affiliates from sharing employees, nothing in the language of that section prohibits a BOC and its affiliate from entering into "arm's length" transactions that allow the affiliate to purchase administrative functions from the BOC.[457]

Discussion:

182. Our *Non-Accounting Safeguards Order* concludes that BOCs are permitted to share in-house services other than operating, installation, and maintenance services with their section 272 affiliates if the agreement to share in-house services complies with the requirements of section 272, including section 272(b)(1)'s "operate independently" requirement, section 272(b)(3)'s "separate officers, directors, and employees" requirement, section 272(b)(5)'s "arm's length" requirement, and section 272(c)(1)'s nondiscrimination requirements.[458] Earlier in this Order, we determined that our affiliate transactions rules should apply to transactions between BOCs and their section 272 affiliates in order to satisfy section 272(b)(5)'s "arm's length" requirement. We conclude, therefore, that our affiliate transactions rules apply to transactions between BOCs and their section 272 affiliates for the sharing of in-house services, including joint marketing services. Moreover, the sharing of in-

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[453] MCI Comments at 36; NYNEX Comments at 30; TRA Comments at 22; Worldcom Comments at 30; Worldcom Reply at 17.

[454] MCI Comments at 36.

[455] Washington Reply at 6.

[456] PacTel Comments at 30; USTA Comments at 25; US West Comments at 21. See also Ameritech Comments at 25.

[457] USTA Comments at 25.

[458] See Non-Accounting Safeguards Order at paras. 178-83.

house services by a BOC and its section 272 affiliate constitutes a "transaction" within the meaning of section 272(b)(5) that must be "reduced to writing and available for public inspection."[459]

183. Our *Non-Accounting Safeguards Order* further concludes that section 272(b)(3) does not preclude an affiliate of the BOC, such as a services affiliate, or the parent company of both the BOC and its section 272 affiliate from performing functions for both the BOC and its section 272 affiliate. Our affiliate transactions rules apply to transactions between the BOC and a nonregulated affiliate of the BOC, such as a services affiliate, and to transactions between the BOC and its parent company. Under the principle of "chain transactions,"[460] our affiliate transactions rules also apply to any transactions between the section 272 affiliate and a nonregulated affiliate of the BOC, such as a services affiliate, that ultimately result in an asset or service being provided to the BOC.[461]

f. Audit Requirements

184. Section 272(d) requires that a company required to operate a separate subsidiary under section 272 "shall obtain and pay for a joint federal/State audit every two years conducted by an independent auditor to determine whether such company has complied with this section and the regulations promulgated under this section, and particularly whether such company has complied with the separate accounting requirements under [section 272(b)]."[462]

185. In the *NPRM*, we tentatively concluded that the independent auditor's report required under section 272(d) should be filed with the Commission and each relevant State commission and should include a discussion of: (1) the scope of the work conducted, including a description of how the affiliate's or joint venture's books were examined and the extent of the examination; (2) the auditor's conclusion on whether the examination of the books has revealed compliance or non-compliance with the affiliate transactions rules and any non-discrimination requirements in the Commission rules; (3) any limitations imposed on the auditor in the course of its review by the affiliate or joint venture or other circumstances that might affect the auditor's opinion; and (4) a statement by the auditor that the carrier's cost

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[459] 47 U.S.C. § 272(b)(5).

[460] See note 376, supra.

[461] NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, Memorandum Opinion and Order, 3 FCC Rcd 5978, 5981 para. 25 (1988) ("NYNEX CAM Order").

[462] 47 U.S.C. § 272(d)(1)

allocation methodologies conform to the Act and the Commission's rules and that the carrier has accurately applied the methodologies described in those rules.[463] We invited comment on this tentative conclusion. We also asked whether the independent auditor's report should address the carrier's compliance with sections 272(e)(3) and 272(e)(4).

Comments:

186. With respect to the form and content of the audit report, TRA and TIA support the Commission's conclusion regarding the information that should be provided in the independent auditor's report required by section 272(d).[464] In contrast, Ameritech, Kiesling, US West, and USTA contend that the independent auditor, in conformance with professional standards, should determine the content and report format.[465] BellSouth and PacTel state that the Commission should not adopt its proposal to require a statement by the auditor that the carrier's cost allocation methodologies conform to the Act.[466] BellSouth contends that this requirement is redundant in light of the Commission's proposal that the auditor include a conclusion as to whether examination of the books has revealed compliance with the affiliate transactions rules and any nondiscrimination requirements.[467] PacTel argues that this requirement exceeds what Congress intended, compelling a broader and more costly audit than required by the plain language of section 272(d).[468]

187. Worldcom, Missouri PSC and CTA state that the audit report should address whether the carrier has complied with sections 272(e)(3) and 272(e)(4).[469] Worldcom further argues that the independent audit required by section 272(d) should include a detailed examination of the BOCs' methods of access imputation.[470] TRA recommends that the Commission require the audit to include a "positive opinion" concerning the carrier's obligation to charge its affiliate or impute to itself an amount for access no less than that

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463 NPRM, 11 FCC Rcd at 9098 para. 93.

464 TIA Reply at 24; TRA Reply at 23.

465 Ameritech Comments at 25; Kiesling Comments at 1; US West Reply at 8; USTA Comments at 25.

466 BellSouth Comments at 39; PacTel Comments at 31.

467 BellSouth Comments at 39.

468 PacTel Comments at 31.

469 CTA Comments at 16; Missouri PSC Comments at 5; Worldcom Comments at 30.

470 Worldcom Comments at 16.

charged to an unaffiliated carrier, the carrier's obligation to provide facilities and services to affiliates at the same rates and on the same terms as all other carriers, and the carrier's obligation to allocate all costs in accordance with Commission rules.[471]

188. The commenters also addressed other aspects of the joint federal/State audit required under section 272(d). Regarding the timing of the audit, MCI, AT&T and NARUC maintain that the Commission should not wait two years to initiate the first audit of BOC compliance with section 272.[472] NARUC states that an audit should be performed and submitted for the first full year of operations after the new subsidiary begins to provide services.[473] AT&T and CTA contend that the Commission should time the first audit so that one additional audit can be performed before section 272's provisions sunset under section 272(g).[474] AT&T and MCI further argue that the Commission should require an annual audit.[475] They maintain that while section 272(d) requires an audit every two years, nothing precludes the Commission from exercising its general authority with regard to accounting matters to require annual audits.[476] Several BOCs argue that the most logical reading of section 272 is that the first audit should not occur until two years after a BOC's section 272 affiliate commences operation.[477] They contend that a Commission requirement of an annual audit would directly conflict with the congressional mandate in section 272.[478]

189. With respect to coverage of the audit, MCI and NARUC maintain that audits should be required of all affiliates whose activities involve or whose revenues are derived from the services specified in section 272, including resale.[479] MCI and NARUC recommend that

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[471] TRA Comments at 24.

[472] MCI Comments at 37; AT&T Comments at 17; NARUC Comments at 15 (Resolution). See also CTA Comments at 17.

[473] NARUC Comments at 15.

[474] CTA Comments at 17; AT&T Reply at 12.

[475] AT&T Comments at 17; MCI Reply at 15.

[476] Id.

[477] See, e.g., Ameritech Reply at 20-21; US West Reply at 8.

[478] See, e.g., Ameritech Reply at 17; SBC Reply at 21; US West Reply at 7.

[479] MCI Reply at 15; NARUC Comments at 16.

one audit be submitted for each of the three services required by section 272 and that each audit cover the last two years of operations.[480]

190. Regarding access to audit workpapers,[481] PacTel and US West urge the Commission to state that workpapers, including material obtained from the examined entities, will receive confidential treatment consistent with section 220(f) and the Commission's policy for Part 64 audits.[482] Ameritech and USTA, however, contend that section 272(d)'s requirements on access to documents, as well as scope and distribution, are clearly articulated and require no further specification by the Commission.[483] MCI and NARUC maintain that access should be given to all working papers with no restriction or time limit placed upon access to data from prior years.[484] NARUC indicates that any State commission having access to the audit workpapers should have provisions in place to ensure the protection of proprietary information as required by section 272(d)(3)(C).[485] NYDPS contends that federal and State regulators should have access to the auditor's workplan and correspondence with the BOC and should be able to attend meetings between the auditor and the BOC where audit procedures and findings are discussed.[486] APCC disagrees that access to auditors' workpapers should be limited only to State utility commissions, the Commission, and any joint audit team formed. APCC argues that access should be provided to any interested party so that such parties can challenge the audit results.[487]

191. To facilitate the biennial audit, AT&T states that the Commission should require all BOC affiliates to make available to the public on a quarterly basis financial reports, an income statement, a balance sheet, and a statement of cash flows.[488]

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[480] MCI Reply at 16; NARUC Comments at 16-18.

[481] Audit workpapers consist of schedules, statistics, and additional information that provide support for an auditor's findings.

[482] PacTel Comments at 31; US West Comments at 27.

[483] Ameritech Comments at 25; USTA Comments at 25.

[484] MCI Reply at 16; NARUC Comments at 14.

[485] NARUC Comments at 5-6

[486] NYDPS Comments at 10.

[487] APCC Reply at 8. See also TIA Reply at 25.

[488] AT&T Comments at 18.

192. Regarding the relation of the biennial audit to the cost allocation manual audit under Part 64, MCI, NYNEX and TIA state that the Commission should clarify that the audit specified in section 272(d) supplements the annual audit required by section 64.904 of the Commission's rules.[489] To the extent that these audits overlap, PacTel contends that the Commission should permit the audit required by section 272(d) to meet the requirement of the section 64.904 annual audit.[490] Ameritech, BellSouth and US West argue that the Commission should conduct the section 64.904 audit in alternate years from the audit required by section 272(d).[491] Ameritech further maintains that each audit should cover only the most recent fiscal period.[492]

193. A number of parties offered recommendations in their comments, replies, and *ex parte* presentations regarding the audit process and the manner in which the Commission, States and the particular BOC should participate in the audit process.[493] NYDPS recommends that the BOC, the Commission and the State affected by the audit should jointly select the auditor.[494] NYNEX states that each carrier subject to a section 272 audit should have the opportunity to participate in the formulation of the audit to ensure its fairness.[495]

194. In its comments, NARUC proposed that the Commission adopt specific audit guidelines for the federal/State joint participation in the audit process.[496] These guidelines would require that a separate federal/State joint audit team be established to oversee the audit process as it relates to compliance with section 272. The NARUC guidelines would establish procedures for selecting the independent auditor through a competitive bidding process using Requests for Proposals ("RFP"). The RFP would address audit purpose and scope, auditor selection criteria, project controls, audit report content, and protection of proprietary data.

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[489] See MCI Comments at 37; NYNEX Comments at 30; TIA Reply at 24. See also 47 C.F.R. 64.904.

[490] PacTel Comments at 31.

[491] Ameritech Comments at 25; BellSouth Comments at 39; US West Comments at 27.

[492] Ameritech Comments at 25.

[493] See Florida PSC Comments at 3-4; Missouri PSC Comments at 4; NARUC Comments at 5-6; NYDPS Comments at 10; Wisconsin PSC Comments at 13; NYNEX Reply at 20; Ohio Reply at 4.

[494] NYDPS Comments at 10.

[495] NYNEX Reply at 20.

[496] NARUC Comments at 5-6 and Appendices A, B, C.

The federal/State joint audit team would develop a set of standards or objectives that every audit must meet. These standards or objectives also would be incorporated into the RFP.

195. The NARUC guidelines would require that a staff member of the federal/State joint audit team follow the progress of the audit and determine whether deadlines and objectives are being met. Upon completion of the audit, the NARUC guidelines would require that the federal/State joint audit team verify that the audit program objectives have been met and determine whether it is necessary for the independent auditor to perform additional audit work.

196. Several State public service commissions recommended that the Commission adopt the proposals advanced by NARUC.[497] USTA and several BOCs, however, argue that the NARUC proposals far exceed the statutory requirements of the Act, and that the Commission should therefore reject them.[498] US West specifically objects to NARUC's proposal to require incumbent local exchange carriers to use an RFP process to select an independent auditor. US West claims that the premise behind NARUC's RFP proposal is apparently that an independent auditor can only be "independent" if selected through a competitive bidding process. US West disagrees, stating that independence is one of the central tenets of the public accounting profession.[499] US West also opposes NARUC's proposal to permit the federal/State audit team to participate in developing the audit program and in determining the scope of the audit.[500] US West argues that this proposal could unnecessarily interfere with the independent auditor's professional responsibility under General Accepted Auditing Standards.[501]

Discussion:

197. We conclude that some of the recommendations in the NARUC comments should be adopted. The purpose of the required audits is to determine whether the BOCs and their separate subsidiaries are complying with the accounting and structural safeguards required by section 272 and to report the audit results to the Commission and the state

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[497] See Florida PSC Comments at 3-4; Missouri PSC Comments at 4; Wisconsin PSC Comments at 13; Ohio Reply at 4.

[498] Ameritech Reply at 21; Bell Atlantic Reply at 7; USTA Reply at 8.

[499] US West Reply at 9.

[500] Id.

[501] Id. See also Ameritech Reply at 22; SBC Reply at 20.

regulatory agencies. To obtain a fair assessment of BOC compliance, we must ensure adequate oversight. From our experience with the cost allocation manual audits under Part 64, we have learned that Commission guidance of the audit process is crucial to assuring that the accounting and structural safeguards are in place and functioning properly. Because of the critical nature of accounting safeguards in promoting competition in the telecommunication marketplace and the critical role the biennial audit will play in ensuring that the safeguards are working, it is essential that we establish effective biennial audit rules at the outset. We conclude that the Commission and the States need to oversee the scope, terms and conditions of the biennial audit. Without such oversight, it would be uncertain whether the audits will achieve their primary objective of ensuring that the carriers have, in fact, complied with section 272 of the Act and our rules.

198. We therefore adopt the NARUC recommendations with certain modifications. Under the rules we now adopt, we delegate authority to the Chief, Common Carrier Bureau to form a federal/State joint audit team with the States having jurisdiction over a BOC's local exchange service. This joint audit team will review the conduct of the audit and direct the independent auditor to take such action as the team finds necessary to ensure compliance with the audit requirements. The new rules require that the structural and transactional requirements and the nondiscrimination safeguards set forth in sections 272(b) 272(c) and 272(e) be subject to audits. The rules, however, do not require the BOCs to choose the independent auditor through a competitive bidding process using a request for proposals as NARUC recommends. The rules preclude the BOCs from hiring independent auditors who have participated during the two years preceding the biennial audit in designing any of the systems under review in the audit. As with the cost allocation manual audits, we conclude that the independent auditor who designs a system should not be the one to certify that it is operating properly.[502]

199. The rules set an orderly schedule for conducting the audit and for submitting the audit report to the Commission and the States as well as to interested parties for comment. The rules call for participation and agreement by the BOC and by the federal/State joint audit team in defining the scope and purpose of the audit prior to its commencement.[503] The rules also allow the federal/State joint audit team to review and, if necessary, direct modifications to

[502] Joint Cost Order, 2 FCC Rcd at 1333 para. 273.

[503] The joint audit team may, for example, conclude that there is a need for more compliance testing or substantive testing than the auditor planned to perform. Compliance testing gives evidence that the company is actually adhering to its internal controls. Substantive testing directly tests account balances shown on the financial statements or the transactions that produce them.

the design of the independent auditor's audit program.[504] Allowing the federal/State joint audit team to participate in this manner at the beginning of the audit is consistent with section 272, because the audit is being conducted to satisfy the Commission and the State public service commissions that the prescribed nonstructural and accounting safeguards have been implemented and are working. Early input from federal/State joint audit team will ensure that the needs of the Commission and the States will be met.

200. The rules prescribe a number of deadlines that parties must meet to avoid prolonged delays in the audit's completion. The final audit report must include: (1) the findings and conclusions of the independent auditor; (2) exceptions of the federal/State joint audit team to the auditor's findings and conclusions; (3) response of the BOC to the auditor's findings and conclusions, and (4) reply of the independent auditor to both the exceptions of the federal/State joint audit team and the response of the BOC. Because the final audit report will become a single source for the audit findings and any exceptions or comments regarding them, interested parties wishing to comment on a particular audit could obtain this information without difficulty.

201. With one exception, discussed below, we have decided to adopt our tentative conclusion regarding the form and content of the auditor's section of the report. We disagree with the parties that contend that we should permit independent auditors to select the content and format of the audit reports.[505] By prescribing a specific report format, we will ensure the consistency and adequacy of all such audit reports. Therefore, in our rules governing the biennial audits required by section 272(d), we will require that the independent auditor's section of the audit report include a discussion of: (1) the scope of the work conducted, with a description of how the affiliate's or joint venture's books were examined and the extent of the examination; (2) the auditor's findings and conclusions on whether examination of the books, records and operations has revealed compliance or non-compliance with section 272 and with the affiliate transactions rules and any applicable nondiscrimination requirements; and (3) a description of any limitations imposed on the auditor in the course of its review by the affiliate or joint venture or other circumstances that might affect the auditor's opinion.

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[504] In planning an audit, the auditor should consider the nature, extent and timing of the work to be performed and should prepare a written audit program (or a set of written audit programs). That program should set forth in reasonable detail the audit procedures that the auditor believes are necessary to accomplish the objectives of the audit. In developing the program, the auditor should be guided by the results of its planning considerations and procedures. As the audit progresses, changed conditions may make it necessary to modify the planned audit procedures. See AICPA Professional Standards, Volume 1, U.S. Auditing Standards AU 311.05 (June 1, 1990).

[505] See Ameritech Comments at 25; Kiesling Comments at 1; US West Reply at 8; USTA Comments at 25.

202. We do not require a statement by the auditor that the carrier's cost allocation methodologies conform to the Act. The carrier's conformance is already reviewed in our cost allocation manual audits under Part 64. Biennial audits review subsidiaries' transactions with the BOCs to which our affiliate transactions rules apply. Based on the reasoning presented in comments filed by CTA, Missouri PSC and Worldcom, we will require that the auditor's section of the report address whether the carrier has complied with sections 272(e)(3) and 272(e)(4).[506] These sections contain provisions that are intended to deter cross-subsidization by the BOCs and, thus, we must know whether the BOCs are complying with them. It is not necessary, however, to adopt TRA's recommendation and require a separate "positive opinion" concerning carrier compliance with sections 272(e)(3) and 272(e)(4) because we are including these requirements as part of the biennial audit.

203. We agree with MCI, AT&T and NARUC that we should not wait two years to require the first audit of BOC compliance with section 272 and we adopt NARUC's suggestion to require the audit to begin at the close of the first full year of operations.[507] We agree with these commenters that nothing in the Act compels us to wait two years after the subsidiary is formed and offering service to begin the audit. The next audit will begin two years later and will cover the operations of the previous two years. This schedule should assure an operational period with adequate information and data to audit. Moreover, such a schedule will allow at least one, and possibly two, audits before the sunset provision of section 272(f) is considered. We will also require that each BOC obtain one audit that covers all affiliates engaged in services specified in section 272(a)(2), including resale, rather than requiring individual audits for each of these services. We believe that one audit of such affiliates should provide the same degree of assurance as could be derived from audits of individual services and has the advantage of providing a comprehensive overview. We do not order an annual audit under our general accounting powers as suggested by AT&T and CTA, because there is no indication that the two-year requirement in the Act will not be sufficient.

204. Workpapers related to the biennial audits, including material obtained from the examined entities, will receive confidential treatment consistent with section 220(f) and the Commission's policy for Part 64 audits.[508] We believe that the requirements in section 272(d)(3) regarding access by the Commission and State commissions to audit workpapers and documents, are clearly articulated and require no further specification by the Commission at

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[506] CTA Comments at 16; Missouri PSC Comments at 5; Worldcom Comments at 30.

[507] MCI Comments at 37; AT&T Comments at 17; NARUC Comments at 15. See also CTA Comments at 17.

[508] PacTel Comments at 31; US West Comments at 27.

this time. As suggested by MCI and NARUC, we interpret these provisions to require access by the Commission and States to all working papers with no restriction or time limit placed upon access to prior years' papers.[509] Any State commission having access to the audit workpapers should have provisions in place to ensure the protection of proprietary information as required by section 272(d)(3)(C).[510] Without such provisions in place, a State commission could neither be represented on the federal/State joint audit team nor participate in the biennial audit. Section 272(d)(3) limits access to audit workpapers and documents under section to representatives of the Commission and of the State public utility commissions.[511] We will not extend this access to other parties as suggested by APCC.[512] This is clearly beyond the scope of section 272(d). We have already addressed NYDPS's contention that federal and State regulators should have access to the auditor's workplan and correspondence with the BOC and should be able to attend meetings between the auditor and the BOC where audit procedures and findings are discussed.[513]

205. We agree with the commenters that suggest that, to the extent the biennial audit and the cost allocation manual audit under Part 64 overlap, we should permit the biennial audit to meet the requirement of the section 64.904 annual audit. This requirement will meet our needs and reduce audit costs for the companies. For a biennial audit to satisfy any part of a cost allocation manual audit, we will require a statement by the auditor that the carrier's cost allocation methodologies conform to the Act. We also note that, unlike the biennial audits, the cost allocation manual audits under Part 64 do not involve State participation. Thus, by relying on the biennial audit, we will allow State participation in the overlapping areas of the audits. In their cost allocation manual audit workpapers, the independent auditors should include copies of the audit work performed under the biennial audit.

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[509] MCI Reply at 16; NARUC Comments at 14. Section 272(d)(3) requires that the auditor's workpapers and supporting materials be made available to the Commission and relevant States. In contrast, section 272(d)(2) addresses only the final audit results, requiring that these results be made available for public inspection.

[510] NARUC Comments at 5-6.

[511] Section 272(d)(3)(a) allows the independent auditor access to "the financial accounts and records of each company and of its affiliates necessary to verify transactions conducted with that company that are relevant to the specific activities permitted under [section 272] and that are necessary for the regulation of rates." 47 U.S.C. § 272(d)(3)(a). It is from such financial accounts and records that the independent auditor develops audit workpapers and other supporting materials necessary for completion of the audit.

[512] APCC Reply at 8. See also TIA Reply at 25.

[513] NYDPS Comments at 10.

2. Section 273 - Manufacturing by Certifying Entities

a. Statutory Language

206. Section 273(d) requires entities that certify telecommunications or customer premises equipment to maintain separate affiliates in order to engage in certain types of manufacturing activities.[514] Under section 273(d)(3), when such an entity certifies telecommunications equipment or customer premises equipment manufactured by an unaffiliated entity, the certifying entity "shall only manufacture a particular class of telecommunications equipment or customer premises equipment for which it is undertaking or has undertaken, during the previous eighteen months, certification activity . . . through a separate affiliate."[515] "[N]otwithstanding [section 273(d)(3)]," section 273(d)(1)(B) prohibits "Bell Communications Research, Inc., or any successor entity or affiliate" from "engag[ing] in manufacturing telecommunications equipment or customer premises equipment as long as it is an affiliate of more than 1 otherwise unaffiliated [BOC] or successor or assign of any such company."[516]

207. Section 273(d)(3)(B) requires the separate affiliate to "maintain books, records, and accounts separate from those of the entity that certifies such equipment, consistent with generally acceptable accounting principles[,]"[517] and to "have segregated facilities and separate employees" from the certifying entity.[518] Section 273(g) permits "[t]he Commission [to] prescribe such additional rules and regulations as the Commission determines necessary to carry out the provisions of this section, and otherwise to prevent discrimination and cross-subsidization in a [BOC's] dealings with its affiliates and with third parties."[519]

b. Comparison of Sections 273 and 272

208. Both sections 272 and 273 require the use of a separate affiliate to engage in different specified activities. In the *NPRM*, we asked whether section 273's different statutory

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[514] 47 U.S.C. § 273(d).

[515] Id. § 273(d)(3).

[516] Id. § 273(d)(1)(B).

[517] Id. § 273(d)(3)(B)(i).

[518] Id. § 273(d)(3)(B)(iii).

[519] Id. § 273(g).

language requires or permits different accounting treatment for standard-setting organizations and their manufacturing affiliates from that required or permitted for BOCs under section 272.[520] We also asked whether we should apply our affiliate transactions rules, as we proposed to modify them, to transactions between all certifying entities, whether regulated carriers or not, and the affiliates they must maintain under section 273(d).

209. In the *NPRM*, we tentatively concluded that application of our affiliate transactions rules, as we proposed to modify them, would be sufficient to satisfy section 273(g)'s requirement that the Commission "prescribe such additional rules and regulations as the Commission determines necessary . . . to prevent subsidization in a [BOC's] dealings with its affiliates and with third parties."[521] We invited comment on this tentative conclusion.

Comments:

210. Several local exchange carriers argue that the affiliate transactions rules should not be modified to govern transactions between a certifying entity and its affiliate if that certifying entity is not also a regulated carrier.[522] In particular, these local exchange carriers argue that it is not within the Commission's authority under the Act to impose regulations on nonregulated affiliates.[523] Ameritech contends that the provisions of section 273(d)(3)(B) that require compliance with GAAP are sufficient and affiliate transactions rules need not be applied to certifying entities and their manufacturing affiliates.[524] Ameritech and USTA contend that to the extent our affiliate transactions rules are considered necessary, these rules satisfy the requirements of section 273(g).[525]

211. TIA argues that the Commission's affiliate transactions rules must be applied, in particular, to transactions between Bellcore and any manufacturing affiliate that it may create in order to prevent cross-subsidization because Bellcore is currently owned by the seven regional BOCs and may remain affiliated with regulated carriers even after it is permitted to

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[520] NPRM, 11 FCC Rcd at 9100-01 para. 97.

[521] Id. at 9101 para. 98.

[522] Ameritech Comments at 25-26; Bell Atlantic Comments at 14. See also USTA Comments at 26.

[523] Id.

[524] Ameritech Comments at 26.

[525] Id.; USTA Comments at 26.

manufacture pursuant to section 273.[526] On the other hand, Bellcore argues that its accounting system already provides the protection required by section 273.[527]

Discussion:

212. We conclude that our affiliate transactions rules, as modified here, satisfy section 273(g)'s requirement that we "prescribe such additional rules and regulations as [we] determine are necessary to . . . prevent . . . cross-subsidization in a [BOC's] dealings with its affiliate." Elsewhere in this Order, we concluded that BOCs are subject to the modified affiliate transactions rules in their dealings with their affiliates engaged in activities permitted under section 272(a), including manufacturing affiliates, in order to assure compliance with the "arm's length" requirement of section 272(b)(5).[528] Accordingly, BOCs that perform certification activities are already subject to the affiliate transactions rules in dealings with their manufacturing affiliates under section 272(b)(5) and current conditions do not warrant additional rules to satisfy section 273(g). In addition, under the principle of "chaining," as long as a certifying entity, such as Bellcore,[529] remains affiliated with a regulated BOC, our affiliate transactions rules apply to any transactions between that certifying entity and its section 273 separated, nonregulated manufacturing affiliate that ultimately result in an asset or service being provided to the BOC.[530]

3. Section 274 - Electronic Publishing

a. Statutory Language

213. Section 274 prescribes the terms under which a BOC may offer electronic publishing. In the *NPRM*, we noted that section 274(a) permits a BOC or its affiliate to

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[526] TIA Reply at 27.

[527] Bellcore Comments at 3.

[528] See discussion in section IV.B.1.b., supra.

[529] Since its creation on January 1, 1984, under the Plan of Reorganization as part of the divestiture of AT&T, Bellcore has been owned and controlled jointly by the regional holding companies of the BOCs. The regional holding companies, however, have recently announced their agreement to sell Bellcore to Science Applications International Corporation, a large defense contractor. Bellcore Owners Sell Business to Defense Contractor, COMMUNICATIONS DAILY, Nov. 22, 1996, at 1. If and when such sale occurs, Bellcore will no longer be affiliated with a regulated BOC and, accordingly, will no longer be subject to the affiliate transactions rules discussed in this section of the Order.

[530] See NYNEX CAM Order, 3 FCC Rcd at 5981 para. 25.

provide electronic publishing over its own or its affiliate's basic telephone service only through a "separated affiliate" or an "electronic publishing joint venture."[531] Section 274(i)(9) defines "separated affiliate" as "a corporation under common ownership or control with a Bell operating company that does not own or control a Bell operating company and is not owned or controlled by a Bell operating company and that engages in the provision of electronic publishing which is disseminated by means of such Bell operating company's or any of its affiliate's basic telephone service."[532] Section 274(i)(8), in turn defines "own" as having "a direct or indirect equity interest (or the equivalent thereof) of more than 10 percent of an entity, or the right to more than 10 percent of the gross revenues of an entity under a revenue sharing or royalty agreement."[533] Section 274(i)(4) states that "'control' has the meaning that it has in 17 C.F.R. 240.12b-2, the regulations promulgated by the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or any successor provision to such section."[534] Section 274(i)(5) defines an "electronic publishing joint venture" as "a joint venture owned by a Bell operating company or affiliate that engages in the provision of electronic publishing which is disseminated by means of such Bell operating company's or any of its affiliates' basic telephone service."[535]

b. Comparison of Sections 274 and 272

214. In the *NPRM*, we noted that the language of section 274's structural and transactional requirements differs from that of the structural and transactional requirements of section 272.[536] We invited comment on whether the distinction between a "separated" affiliate under section 274 and a "separate" affiliate under section 272 requires or permits different accounting treatment for affiliate transactions. Specifically, we sought comment on whether we should apply our affiliate transactions rules, as we proposed to modify them, to

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[531] NPRM, 11 FCC Rcd at 9102 para. 101. See also 47 U.S.C. § 274(a). "Joint venture" is not defined in section 274 or in other sections of the Act. Black's Law Dictionary defines "joint venture" as "a legal entity in the nature of a partnership engaged in the joint undertaking of a particular transaction for mutual profit" or "a one-time grouping of two or more persons in a business undertaking." Unlike a partnership, a joint venture does not require a continuing relationship among the parties. BLACK'S LAW DICTIONARY 584 (abridged 6th ed. 1991).

[532] 47 U.S.C. § 274(i)(9).

[533] Id. § 274(i)(8).

[534] Id. § 274(i)(4).

[535] Id. § 274(i)(5).

[536] NPRM, 11 FCC Rcd at 9104-05 para. 105.

transactions between a BOC and its "separated" electronic publishing affiliate or joint venture. We sought comment on whether application of these rules would provide adequate accounting safeguards for the joint activities permitted under section 274(c)(2). We also invited comment on whether, because section 274 allows a BOC to provide electronic publishing through either a "separated" affiliate or a joint venture, we should distinguish for Title II accounting purposes between transactions involving a BOC and its "separated" affiliate and those involving a BOC and its electronic publishing joint venture.

Comments:

215. NAA and several BOCs contend that the differences in language between sections 274 and 272 do not require the Commission to impose different accounting treatments for those affiliate transactions governed by section 274 and those governed by section 272.[537] They also argue that the Commission's affiliate transactions rules provide adequate accounting safeguards for the joint activities permitted under section 274(c)(2).[538] In contrast, YPPA argues that, by placing electronic publishing in a separate section of the Act, Congress intended the Commission to implement different accounting requirements for sections 272 and 274.[539] YPPA does not, however, suggest how the requirements should differ. In addition, USTA and several BOCs argue that the Commission need not distinguish for Title II accounting purposes between transactions involving a BOC and its "separated" affiliate and those involving a BOC and its electronic publishing joint venture. [540]

216. SBC notes that the Commission's existing affiliate transactions rules would not apply to transactions between a BOC and certain "separated" affiliates and joint ventures when the BOC has insufficient ownership interest in the "separated" affiliate or joint venture for those entities to qualify as BOC affiliates under section 32.9000 of the Commission's rules. [541]

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[537] See, e.g., Ameritech Comments at 26; NAA Comments at 2; PacTel Comments at 32; SBC Comments at 48; US West Comments at 16 & 20.

[538] See, e.g., Ameritech Comments at 26; BellSouth Comments at 41; NAA Comments at 2; NYNEX Comments at 30; US West Comments at 22. See also USTA Comments at 26.

[539] YPPA Comments at 2.

[540] See, e.g., Ameritech Comments at 26; Bell South Comments at 41; NYNEX Comments at 30; USTA Comments at 26; US West Comments at 22.

[541] SBC Comments at 48.

217. BellSouth maintains that section 274's requirement of a "separated" affiliate for the provision of interLATA information services facially violates BOCs' First Amendment right of freedom of speech and constitutes an unconstitutional Bill of Attainder.[542]

Discussion:

218. We conclude above that our affiliate transactions rules must be applied to transactions between BOCs and their section 272 affiliates in order to satisfy section 272(b)(5)'s "arm's length" requirement.[543] The language of section 274's structural and transactional requirements differs from that of the structural and transactional requirements of section 272. Section 274 does not specifically use the phrase "arm's length" to describe the required nature of transactions between BOCs and their section 274 "separated" electronic publishing affiliates or joint ventures. Section 274(b), however, requires that "separated" electronic publishing affiliates or joint ventures "be operated independently from the [BOC],"[544] and section 274(b)(3)(A) requires that transactions between a "separated" electronic publishing affiliate or joint venture and its affiliated BOC be carried out "in a manner consistent with such independence."[545] Moreover, section 254(k) prohibits incumbent local exchange carriers, including the BOCs, from using non-competitive exchange service and exchange access to subsidize competitive services, such as electronic publishing.[546] We conclude that in order to satisfy sections 274(b) and 254(k), we must apply our affiliate transactions rules, as modified in this Order, to transactions between BOCs and their "separated" electronic publishing affiliates or joint ventures. Applying our affiliate transactions rules to transactions between BOCs and their "separated" electronic publishing affiliates or joint ventures will serve as a safeguard against the misallocation of costs from a BOC's nonregulated services, such as electronic publishing services, to regulated telecommunication services. Our affiliate transactions rules, as modified in this Order, prevent the BOCs' ratepayers from bearing the costs of competitive services provided by BOC affiliates and are, therefore, sufficient to implement section 254(k)'s requirement that carriers

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542 BellSouth Comments at 40.

543 See discussion in section IV.B.1.b., supra.

544 47 U.S.C. § 274(b).

545 Id. § 274(b)(3)(A).

546 Id. § 254(k).